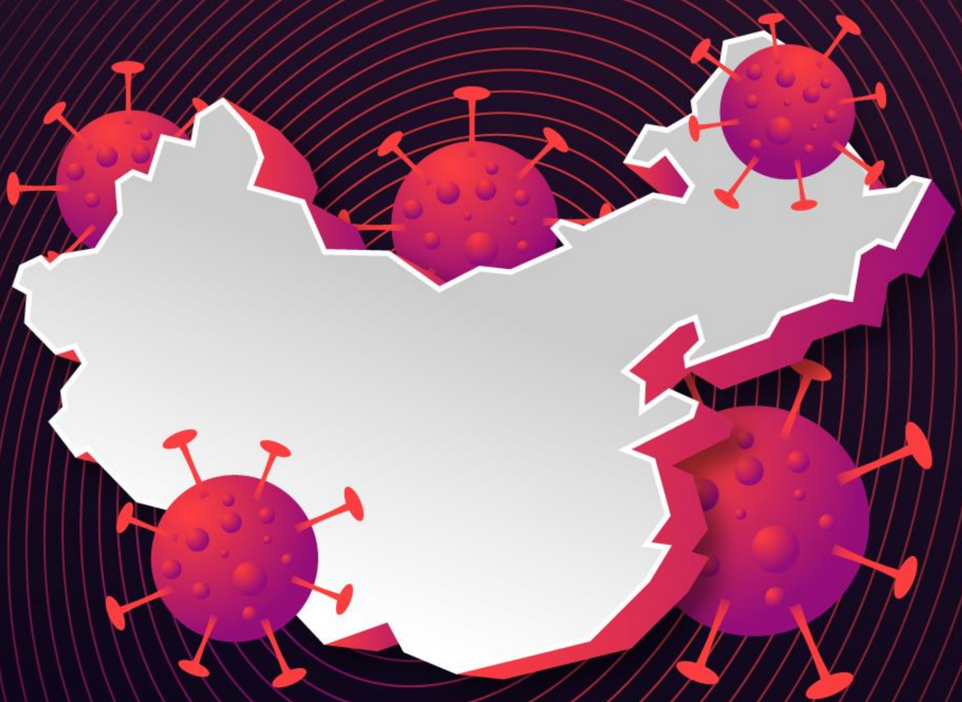
The COVID-19 Coverage

What is happening in China?

Evalueserve Intelligence: Sector Memos
Critical Updates & Preliminary Assessment



April 2020

Image: Freepik.com

Background

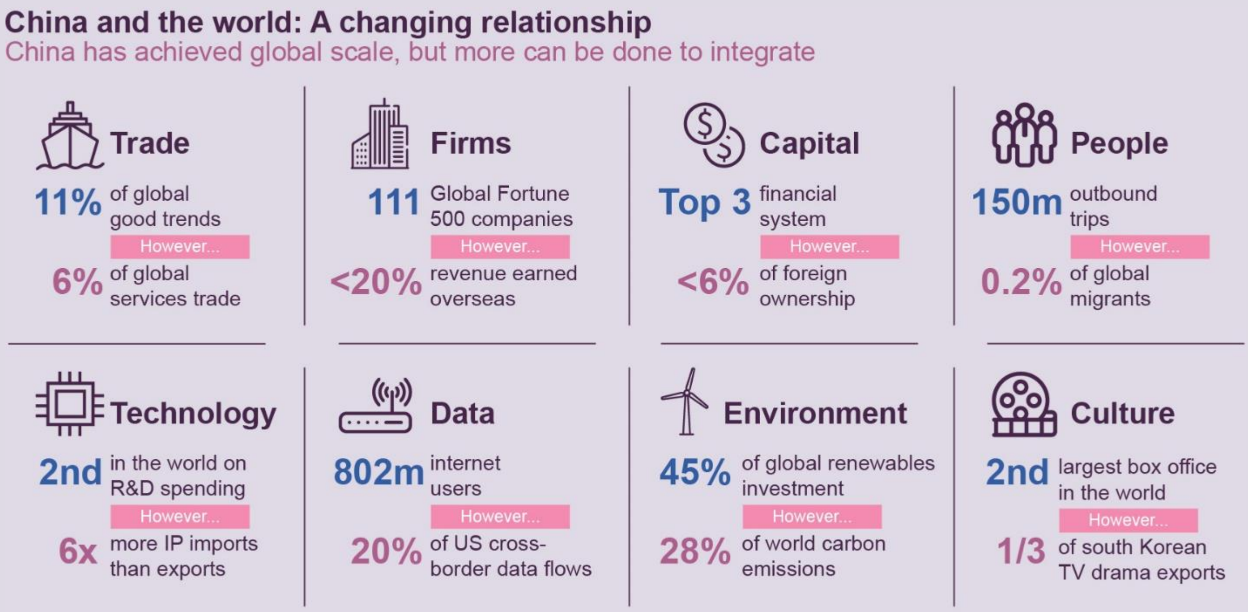
Amid a global crisis of unprecedented scale, professional advice, expertise, and active support are more critical than ever for business leaders across the globe. The COVID-19 pandemic not only ends an uninterrupted bull-run since the global financial crisis of 2007–08, but also stress-tests business models, global supply chains, and the war chests of companies globally.

The Executive Report, COVID-19 Sector Memos (What is happening in China – April 2020), provides preliminary assessment and overall view of the ongoing cross-sector activity in China. The report aims to present the emerging risks, regulations, as well as opportunities from the COVID-19 outbreak. Since this report is time sensitive, forward-looking outlook may require ongoing monitoring.

The China Entanglement: Why is it important to look at China as the COVID-19 crisis unfolds?

- According to the World Bank, a severe pandemic could wipe out 5% of global GDP (or more than $3 trillion) and severly impact global trade. The SARS crisis of 2003-04 led to $40 billion in global market losses. Unsurprisingly, China's share of world trade has almost doubled since the SARS outbreak. Fast forward to the present, the COVID-19 pandemic tests world’s dependence on China for technology, trade and capital. In an effort to build a self-sustaining economy, China’s economy has been reducing its reliance on trade as a source of growth.
- China’s economic slowdown is likely to impact different regions of the world in different ways depending on their exposure and reliance on China. The slowdown in demand could have a negative impact on the GDP growth of countries that are dependent on China for commodity exports. However, the recent fall in commodity prices could be beneficial for countries that import commodities, such as the US and several European nations.
- The COVID-19 crisis will have strategic and long-term implications on global trade. Economies will highly likely moderate their over-reliance on and businesses hedge their risk exposure to China in the aftermath of the crisis, by reducing commodity exposure, diversifying and looking for alternate supply chains, hedging investment risk, preparing better risk transfer solutions and policies, and more…
- A recent study conducted by McKinsey Global institute* concluded, “China is becoming less exposed in economic terms to the rest of the world. However, reflecting China’s rise to being the world’s second-largest economy and its leading trading nation, the rest of the world is becoming more exposed to China…”

Some interesting facts from the report are highlighted below to set a stronger context for Sector Memos that follow:



Source: McKinsey Global Institute - China and the world: Inside the dynamics of a changing relationship, July 2019*

Sources: The World Bank Report – A World at Risk - Sep 2019, Mckinsey Global Insititute – China and the world - Jul 2019*, Learning from SARS: Preparing for the Next Disease Outbreak: Workshop Summary by National Academics Press (US) – 2004, The Balance, NIKKEI Asian Review

Emerging Risks, Reg and Opportunity

COVID-19 Newswire across Sectors with Focus on China

Sector	Key Players (Domestic & Foreign)	COVID-19 Newswire Emerging Risk-Reg-Opportunity
Banking	*Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China, Bank of East Asia, HSBC, Citibank*	• **Risk:** China could face decade-high bad loan ratio as COVID-19 slams small businesses, SCMP - Mar 2020 • **Reg:** PBOC Establishes "Green Pipeline" for Issuance of Bonds by Chinese Financial Institutions During COVID-19 Outbreak, China Banking News - Feb 2020 • **Opportunity:** HSBC China launches SMO, as going digital is prioritized amid COVID-19, IBS Intelligence - Apr 2020
Insurance	*China Life, Ping An Insurance, China Pacific Insurance, AXA, Allianz, Prudential*	• **Risk:** COVID-19 to put a dent in Chinese insurers' earnings – Insurance Business - Feb 2020 • **Reg:** China Issues Rules for Insurance Companies' Asset Management Products, Caixin - Mar 2020 • **Opportunity:** Chinese insurance industry set for strong growth between 2019-23 despite COVID-19, GlobalData - Apr 2020
Energy	*China National Petroleum Corp (CNPC), Sinopec, China National Offshore Oil Corporation (CNOOC), Dongming Petrochemical Group, Exxon Mobil, Chevron Corp,. Royal Dutch Shell*	• **Risk & Reg:** Xi Ordered China's Oil Industry to Drill, Then the Crash Came, Bloomberg - Mar 2020 • **Opportunity:** Oil price crash to reverberate through LNG markets, S&P Global - Mar 2020 • **Opportunity:** China's teapot oil refineries could become 'money-printing machines' amid crude price crash, SCMP - Mar 2020
Technology	*Tencent, Baidu, Alibaba, Apple, Samsung, Alphabet*	• **Opportunity:** China's Big Tech companies are using their roles in fighting world's largest health crisis to turbocharge HealthTech, SCMP - Mar 2020 • **Risk:** IDC: COVID-19 will drag down China's ICT market by 10% in the first quarter of 2020, Fierce Telecom - Feb 2020 • **Opportunity:** COVID-19 How Artificial Intelligence, Data Science And Technology Is Used To Fight The Pandemic, Forbes - Mar 2020
Automotive	*Dongfeng, Changan, SAIC, GM, Volkswagen Group, Toyota, Tesla*	• **Risk:** COVID-19 - China manufacturing hub Dongguan faces grim test as global export orders vanish, SCMP - Apr 2020 • **Opportunity:** COVID-19 - China manufacturing economy bounces back strongly after lockdown, SCMP - Mar 2020 • **Risk:** Chinese factories face new threat: US anti-virus controls, AP - Mar 2020
PLS & Healthcare	*Shanghai Pharmaceuticals, Sinopharm Group, Jiangsu Hengrui Medicine, Pfizer, Roche, Novartis*	• **Risk:** China's COVID-19-induced supply chain woes fan concerns of possible drug shortages, Reuters - Mar 2020 • **Opportunity:** Investment Opportunities in China's Healthcare Sector After COVID-19, China Briefing - Mar 2020 • **Opportunity:** China's healthcare spending tipped to grow 12.6% to $926.8b in 2020, Healthcare Asia - Mar 2020
Retail	*Suning, Gome, China Resource Vanguard, Walmart, Costco, LVMH, Starbucks, McDonalds*	• **Opportunity:** Online shopping in China surges amidst COVID-19 outbreak; increase in first-time shoppers in lower-tier cities, GFK - Mar 2020 • **Risk:** Half of Chinese Retailers Risk Collapse Within Six Months, Bloomberg Quint - Mar 2020 • **Risk:** COVID-19 wreaks havoc on retail supply chains globally, even as China's factories come back online, CNBC - Mar 2020

Table of Contents

Macroeconomic Outlook

China's economic outlook remains uncertain despite early signs of recovery

- The Chinese economy was hit hard in January-February 2020, with drastic declines in fixed asset investment (-24.5%), industrial production (-13.5%), and services production (-13.0%). Its exports in the same period plunged 17.2% YoY, while imports fell 4.0% YoY.[1, 2]
- China's official urban unemployment rate for January-February 2020 reached a record 6.2%, with an estimated 5 million jobs lost in the period. Analysts expect the unemployment rate to go higher than 10%, as economic activity in the next quarter will likely be subdued due to lingering disruptions to the manufacturing supply chain, slow recovery in the services sector, and a steep fall in demand from the rest of the world.[3, 4]
- The government quickly swung into action with policy initiatives to prop up the economy, including:
  - Tax cuts for small businesses and new infrastructure projects to boost growth.
  - China's central bank, People's Bank of China (PBoC), injected CNY1.2 trillion ($174 billion) into the financial system and lowered benchmark lending rates to make more money available for lending to businesses.
  - The government further announced more than CNY3 trillion ($423 billion) in additional financial support for small businesses.[5, 6]
- Business sentiment seems to have improved owing to the various policy initiatives, as manufacturing activity has shown a rebound. China's official manufacturing purchasing managers' index (PMI) rose from 35.7 in February to 52.0 in March. Government data showed that 96.6% of large firms had reopened as of the last week of March, compared to 71.7% of smaller companies. However, new orders, including export orders, have declined as the contagion has spread rapidly across the world. [7, 8]
- The economy is still poised for a recession in Q1 2020, with GDP expected to decline YoY. Various estimates predict the scale of Q1 2020 GDP decline to be between -3% and -15%. For the full year 2020, the World Bank expects 2.3% GDP growth (baseline scenario) for China, compared with 6.1% in 2019.[9,10]

Way Forward

Chinese policy makers may look at more policy measures to boost demand as supply-side disruptions are gradually easing. Chinese customs administration and the National Bureau of Statistics (NBS) will release March trade and other economic data, including first-quarter GDP numbers, in mid-April. This data will help explain the real impact of the pandemic on the Chinese economy and may guide policy decisions by the government. However, China's economic recovery may be prolonged due to uncertainties posed by a variety of factors, including a second wave of infections, an expected global recession, worsening deflation due to falling oil prices, and a potential slide in the property market.

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1 COVID-19 crash: How China's economy may offer a glimpse of the future, World Economic Forum, March 31, 2020
2 China Jan-Feb dollar-denominated exports tumble 17.2%, imports down 4%, Reuters, March 6, 2020
3 China factory activity unexpectedly expands, but economy cannot shake off virus shock, Reuters, March 31, 2020
4 China's economy has yet to reach bottom, FT.com, April 2, 2020
5 China's Economic Recovery and Equity Markets, Goldman Sachs, March 31, 2020
6 China's economy may not grow at all in 2020. That hasn't happened in 44 years, CNN Business, April 1, 2020
7 Coronavirus: China's small factories stabilised in March after lockdown, private PMI shows, South China Morning Post, April 1, 2020
8 China's PMI, National Bureau of Statistics of China, accessed on April 4, 2020
9 China 2020 GDP to slow to 3.3%, lowest since 1976: survey, Nikkei Asian Review, March 31, 2020
10 Pandemic to hit growth in Asia, China: World Bank, Reuters, March 31, 2020

Deals Activity

Recent deal activity signals an early recovery in China

Deal activity in China came to a standstill with the onset of the COVID-19 outbreak in late 2019. The disruption in operations led to a 35.8% YoY decline in M&A deal value, to $51.3 billion, in Mainland China and Hong Kong, while deal volume was down 32.5% YoY to 268 transactions in Q1 2020.[11] In 2019, China was engaged in a trade war with the US, and subsequently, M&A activity in the country declined 27.7% YoY to $294.5 billion.[12]

- **M&A transactions:** In light of the outbreak, bankers have been faced with travel restrictions and are thus unable to carry out face-to-face negotiations, which has given leverage to parties with a upper hand in a deal to take advantage of the situation. Five of the 10 global terminated deals in March 2020 involved Chinese targets.[13] However, high-stakes M&A deals are still on the table because of their long-term value. For outbound investments, the Chinese are finding European deals more lucrative due to lower valuations.[14] There is uncertainty when it comes to inbound investments, however, since the banking, travel, and airlines sectors have been badly hit, and companies are facing a severe cash crunch. These companies are continuously looking for equity injection, and in the SME layer, the additional pressure may increase the already growing consolidation.
- **IPO transactions:** Transactions worth $11 billion in valuations were recorded in the IPO market in Q1 2020.[15] The transactions received a boost when the stock market re-opened in February post the Lunar New Year. However, promotional activities remain muted during the lockdown, which has had an impact on IPO transactions overall.
- **VC transactions:** Private Equity/Venture Capitalist (PE/VC) transactions saw an uptick in the last week of March from the advanced manufacturing and edtech sector. During the first six weeks of 2020, deal volume and capital raised in China fell more than 60%, compared with the same period last year.[16] Resultantly, regulatory bodies have relaxed certain norms in the country to encourage deal activity. For example, China Securities Regulatory Commission (CSRC) relaxed share-sale restrictions for VC funds with more than five years of investments after the expiry of lock-up periods.[17]

Way Forward

In the short term, companies may shift their strategic focus toward rescue deals, internal restructuring, and other stability-focused mergers. Meanwhile, China's new foreign investment law, which was introduced on January 1, 2020, is expected to help boost foreign investments by creating a level playing field for foreign investors. Although corporates have pushed their investment, expansion, and other restructuring decisions for later, there are high expectations that the deal scenario will recover relatively fast in China and see normal growth in the next 3-6 months. Emerging markets continue to be the focus of Chinese investments, whereas Industrial, Consumer Goods, Technology, and Financial Services continue to be the targeted sectors.

[11] Global and regional M&A report Q2 2020, Mergermarket, April 02, 2020
[12] Mergermarket releases 4Q19 M&A report, Mergermarket, January 02, 2020
[13] ANALYSIS: Where Are All the M&A Deal Terminations?, Bloomberg, March 17, 2020
[14] China's Corporates Are Gearing Up in Europe for M&A Bargains, Bloomberg, April 07, 2020
[15] China defies coronavirus to top global listings in first quarter, FT.com, April 01, 2020
[16] China's VC industry bounces back after coronavirus-induced winter, Pitch book, April 02, 2020
[17] China eases venture capital divestment rules to aid virus-hit economy, Reuters, March 06, 2020

Financial Services: Banking

Debt overload and margin squeeze are here to stay for the $44 trillion banking industry

While regulators in China have been cracking down in the last few years on shadow banking as part of the government's financial reform plan,[18] the COVID-19 outbreak has shifted focus toward regulatory easing and providing lending stimulus to some of the hardest hit sectors: manufacturing, energy, transportation, and retail.

- **Lending curve to slide down, owing to looming interest rate cuts.** PBoC has been pushing down borrowing costs in a synchronized effort to provide lending stimulus to the economy. A succession of cuts (1Y Medium Lending Facility on or before April 20, and the 1Y Loan Prime Rate on April 20) may closely follow the most recent cut in the 7D reverse repo rates (announced March 30). Lowering banks' lending rates without a reduction in the cost of their liabilities will squeeze banks' net interest margins, eroding their profitability and capital buffers.[19]
- **Big lenders hit hard, but risk bigger for smaller banks.** Profitability for China's biggest banks – Industrial and Commercial Bank of China (ICBC), Bank of China, Agricultural Bank of China, and China Construction Bank – is expected to take a hit from a spike in non-performing loans and further compression in net interest margins (an estimate of 10-12 bps in 2020), as state-owned enterprises pay a "national service" to support the economy at the expense of profits.[20] However, "China Financial Stability Report," published in November 2019, concluded that more than 13% of China's banks were at "high risk." It also stressed on the need for liquidity management and greater support for regional and rural lenders.[21]
- **Regulatory accommodation comes with hidden costs.** The outbreak is likely to add billions in credit losses for banks in the Asia-Pacific region this year as regulators allow banks to raise their tolerance for non-performing loans. In China alone, S&P Global Ratings estimates the level of non-performing loans may triple, an increase of $800 billion. Beijing's regulatory reprieve on reporting delayed delinquencies to the country's centralized credit-scoring system could grossly under-report real credit costs in the future. The non-performing loan ratio is likely to peak sharply from 'moderate' to 'very high' in the aftermath of the crisis.[22]

Way Forward

Foreign banks in China: *Large global banks have lower direct exposure to China. However, Hong Kong, a special administrative region under China, is a key market for international banks. Combining China and Hong Kong, Citigroup's $64.6 billion exposure is closer to 4% of the company's total assets. By comparison, JPMorgan Chase (JPM) has $24.7 billion; Bank of America Corp (BAC) has $23.4 billion; and Wells Fargo & Company (WFC) has only $3.4 billion in total exposure to China and HK combined*. However, experts warn of "secondary" impacts from a slowing Chinese economy. US banks are also exposed to more indirect risks through equity trading, foreign exchange businesses, and their US business loan portfolios. These invisible interconnections should not be understated, and the risk could be more than what appears on books.*

Domestic exposure: *Domestically, the resilience of China's banking system could be severely tested by the State Council's proposed credit expansion at rates below 5%. Because of the COVID-19 outbreak, health emergencies and production delays in China could cause non-performing loan ratio to triple to about 6.3%, further accentuated by low demand from mortgages and SMEs. This could be catastrophic for the five state-owned banks that had over CNY2.6 trillion of exposure in the Hubei province in 2018, closely followed by local and foreign lenders. Banks may struggle to cover their cost of generous funding after accounting for default risks. In addition, China's annual banking stress tests outlined that a negative scenario of economic growth faltering to as low as 4.15% could trigger a five-fold increase in bad loans among the nation's 30 biggest lenders. The debt overload, coupled with their relatively limited liquidity, is a major foundational risk that lenders will need to manage. Banks must also prepare for a distressed debt aftershock.*

[18] China must not choke off the private sector's access to credit in the name of deleveraging, South China Morning Post, January 27, 2020
[19] Coronavirus: China slashes bank loan rate by biggest amount in five years, joining global easing, South China Morning Post, March 30, 2020
[20] China's big four banks face coronavirus profit hit, FT.com, April 1, 2020
[21] Over 13% of Chinese Banks Categorised as High Risk, More than One Third of Rural Lenders: PBoC, China Banking News, November 26, 2019
[22] Trade finance revenues to take coronavirus hit as risk of default hike looms, S&P Global MI, March 11, 2020 ; * Yahoo Finance estimates

Financial Services: Insurance

Near-term headwinds on insurers' earnings steady, difficult to diversify risk amid a global pandemic

China remains one of the fastest growing insurance markets in the world, with pre-crisis expectations of 3% growth in 2020 and 2021, according to Swiss Re.[23] However, the COVID-19 pandemic could trim those estimates, as slowdown in economic activity, deterioration in equity markets, and a low rate environment could weigh on insurers' earnings, reserves, and capital buffers.

- **Playing the role of social stabilizers, insurers face losses from payouts and exhibit divergence in performance**. Life insurers are facing the double threat of a collapse in bond yields and bigger policy losses. For example, HK-based life insurer AIA, which witnessed slow growth in new business mainly from anti-government protests in the prior year, is expecting further deterioration from the COVID-19 outbreak.[24] On the other hand, Ping An, China's largest insurer by market value with diverse technology offerings, is seeing a jump in customer acquisitions through online health solutions, which has offset some weaknesses in its traditional products. Moreover, property and casualty insurers could see modest impact in the auto and property lines.[25]
- **Slowdown in economic activity and rise in competition could put pressure on premiums**. Business lines in life and auto insurance could see a decline in premiums as customers prioritize health insurance and postpone vehicle purchases. Further, the COVID-19 outbreak has led to an increased awareness on pandemic protection solutions and health-related emergencies, creating new opportunities and revenue streams for insurers. For example, China's southern province of Hainan has co-launched the first specially designed insurance product to cover losses incurred by businesses as a result of the COVID-19 outbreak in the country.[26]
- **Insurers face regulatory risk if policy exclusions become legally binding.** Several Chinese insurance companies, including China Life, Junkang Life, Xinhua Insurance, Taikang Life, Ping An Life, Dingcheng Life, and Aixin Life, have extended their responsibilities for some categories of insurance contracts to include the new coronavirus pneumonia. Insurance companies may not add premiums due to this "extended liability," which means that the extra cost will be borne by the insurers themselves. Lawmakers are considering forcing retroactive policy changes to cover COVID-19 business-interruption claims and make it easier to invoke a *force majeure* clause not previously triggered by the virus. On the regulatory front, China's goal to open its market to foreign insurers could lead to an influx from global insurers, at a time when growth in developed markets remains elusive.[27]

[23] Driven by strength in emerging Asia, insurance markets will grow despite weakening global economic growth, Swiss Re, November 13, 2019
[24] AIA Group's 2019 growth in new business value slows to 6%; flags COVID-19 impact, Nasdaq, March 11, 2020
[25] Chinese insurance industry set for strong growth between 2019-23 despite COVID-19, GlobalData, April 2, 2020
[26] Chinese province launches insurance for businesses hit by coronavirus, Reuters, February 17, 2020
[27] Fitch Revises Outlook for APAC Non-Life Sector to Negative Due To COVID-19; Fitch Ratings Revises Rating Outlook for APAC Life Insurance to Negative, Fitch Ratings, Fitch Ratings, March 23, 2020

- **Innovation and digital transformation will differentiate winners from losers**. With face-to-face interactions on a decline, insurers are set to accelerate digitization and product innovation across the value chain using emerging technologies, AI, and blockchain in claims processing. Digitization of services and solutions will rapidly proliferate and witness a mass adoption across the industry.[28]

Way Forward

While the Chinese economy is trying to bounce back from the staggering crisis, the long-term impact on the insurance industry remains fragmented, broadly varying by individual lines' exposure to risk and investment portfolios. Life insurers are the most vulnerable, with exposure to risky assets in volatile market conditions, low interest rate environment, coupled with the increase in mortality rate and cash flow strains, specifically for providers with higher dependence on single premium policies. Property and casualty business lines are heading toward a prolonged deterioration, driven by a surge in claims from aviation, travel insurance, credit insurance, and contingency or event cancellations, offsetting any positive decline in claims for the auto segment.

Further, Chinese insurers are exposed to risk from inter-dependenices in global supply chains and trade. Moodys predicts that rising claims will hit three of the world's biggest trade credit insurers, Atradius, Coface, and Euler Hermes, which have high exposure to vulnerable sectors like hotels and airlines in Asia. In China, several insurers have already taken drastic steps by withdrawing credit insurance coverage. Euler Hermes, a trade insurer, predicts that roughly $320 billion will be trimmed from global trade per quarter in 2020 as corporate insolvencies continue to escalate globally. In particular, China's total damage to exports from the crisis could stand close to $190 billion. However, benchmarking it against the last pandemic (SARS), exports may rebound and most damages may still well be within insurers' and reinsurers' capital tolerances in the long term.[29]

[28] Insurance service providers rely on blockchain to fast track claims payout amid coronavirus outbreak, South China Morning Post, February 9, 2020
[28] China: Coronavirus: China's trade economy slowly coming back to life, but US$190 billion export hit expected, SCMP, March 27, 2020

Industrial Manufacturing

Chinese manufacturing rebounds, but economic recovery still far

Since China is the central manufacturing hub for many global businesses, the impact of the COVID-19 outbreak has disrupted the entire global supply chain, besides domestic manufacturing activities.

- **Impact of COVID-19 on China's manufacturing activity:** China's manufacturing activity slowed down dramatically during the first two months of 2020, as the government instituted large-scale lockdowns and quarantines to contain the spread of COVID-19.
- **Signs of recovery in March 2020:** The purchasing managers' index (PMI) released by China's National Bureau of Statistics (NBS) surged to 52.0 in March 2020, from a record low of 35.7 in the previous month, beating market expectations of 45.0. The reading pointed to the strongest pace of expansion in the sector since September 2017, as many companies resumed operations following the lockdown in February.[30]
- **Recent surge could be a one-off gain:** Although China's PMI reading for March was in the expansionary zone, it was just a few points above 50, with raw material inventory and delivery time still remaining in the "contraction territory."[31] As the virus has now spread exponentially across 209 countries* (including the US, the UK, and Europe), its economic impact is expected to be more severe and long-lasting. Moreover, a potential second wave of COVID-19 infections could pose even bigger risks for the country's manufacturing sector.[32]

Way Forward

The recent uptick in China's manufacturing activity may be short-lived, as the pandemic that originated in China has now spread to the rest of the world, leaving the global economy vulnerable to a deep recession. Given China's high dependency on exports, the current pessimistic outlook may lead to order cancellations. Many Chinese manufacturers have already paid in advance to buy raw materials, and any cancellation or postponement of orders would further increase their risk and uncertainty. However, the recovery is likely to be quicker for companies focused on domestic market.

The PMI index forecasts of 46.2 in June 2020 and a little above 50 in December 2020 indicate that there is still a significant drag on China's economy, and that it may take at least a few quarters to get back to normalcy. We believe that the recent surge in manufacturing activity is a one-off gain from the very low comparison base in February, and is constrained by China's efforts to guard against a second wave of infections from abroad.[33]

While the economic challenges are potentially devastating, the political consequences – though difficult to foresee – might be the most long-lasting. The origination of the COVID-19 pandemic in China and the way the whole incident was initially handled by the Chinese administration could act as a wake-up call for world economies, thereby leading to a reduction in China's influence on global manufacturing.

As such, the possibility of gradual diversification, away from a supply-chain based in China to other locations, cannot be ruled out in the long run.[34]

[30] China manufacturing shrinks at record pace: NBS, Trading Economics, updated March 31, 2020
[31] China manufacturing shrinks at record pace: NBS, Trading Economics, updated March 31, 2020
[32] Chinese county goes into coronavirus lockdown amid fear of second wave, Politico, April 1, 2020
[33] Chinese county goes into coronavirus lockdown amid fear of second wave, Politico, April 1, 2020
[34] Coronavirus could be the end of China as a global manufacturing hub, Forbes, March 1, 2020, * Worldometers (as of April 9, 2020)

Pharma Life Sciences and Healthcare

COVID-19, a catalyst for China's healthcare sector

While China appears to return to normalcy, we still see some restrictions on promotional activities in Wuhan/Hubei. The novel coronavirus (COVID-19) outbreak could pressurize Chinese drug/medtech supply chains, but steady demand should secure growth.

- As a world-leading active pharmaceutical ingredient (API) supplier, China is highly integrated into global supply chains. China's API production is recovering after a few weeks of shutdown, with production efforts focused on APIs in highest demand, including hydroxychloroquine.[35] At the same time, overall demand for pharmaceuticals is rising, as the population in a large number of countries ages. This may also provide a much-needed boost to the recovering sector.
- Following a steep rise in worldwide demand, China has emerged as a major exporter of medical supplies, though quality remains a major challenge. A recent update to its medical supply exports policy shows that China is intensifying scrutiny to control quality scams.[36]
- The following learnings gained from managing the COVID-19 outbreak could greatly transform China's healthcare market, which had been projected to reach $2.3 trillion by 2030.[37]
  - There is substantial variation in the capabilities of hospitals across regions in China; the country's physicians-to-people ratio is relatively low, compared with Japan and the US.[38]
  - Biotech is one of the key sectors identified for development under China's 'Made in China 2025' industrial strategy. Although the segment has been around for a decade, the majority of biotech investment has gone into oncology. The outbreak has emphasized upon Chinese biotech / biopharma players the importance of developing strong in-house R&D capabilities and moving away from a homogeneous approach.
  - The COVID-19 outbreak disrupted sales and marketing activities the most. These are now top-of-mind activities for all C-suite members. Around 60% of large companies are already reviewing the possibility of implementing new technologies to engage healthcare providers, hospitals, and patients.[39]
  - Technology players (AI, drones, 3D-printing, and robotics) and digital health have gained a considerable number of new users in just the past few weeks. Chinese patients expect to use more digital services within the next five years.[40]

[35] Chinese APIs flowing but India ban hinders U.S. approval of hydroxychloroquine, FiercePharma, March 31, 2020
[36] Announcement No. 5 of 2020 of the General Administration of Customs of the Ministry of Commerce of the People's Republic of China on the Export of Medical Materials in Order, Ministry of Commerce of the People's Republic of China, March 3, 2020
[37] Investment opportunities in China's Healthcare Sector after COVID-19, China Briefing, March 25, 2020
[38] Investment opportunities in China's Healthcare Sector aaafter COVID-19, China Briefing, March 25, 2020
[39] Snapshot survey of COVID-19 impact on China pharma industry, Deloitte, February 2020
[40] How the Coronavirus will transform healthcare in China, Bain & Company, March 04, 2020

In view of its rapidly aging population, China's health sector was already positioned to become an area of priority for the government in the coming decade. We believe that the current public health crisis will prompt an upgrade in healthcare spend, and healthcare professionals and service providers will be at the center of many reforms, going forward.[41] Biotech investment is expected to be diversified across areas such as vaccines and antiviral medication.

Way Forward

While higher healthcare spend was already expected as a long-term trend, the outbreak is likely to increase investment in China's healthcare system (for structural reforms, education, preventive health care, and technology deployment). There should be significant opportunities for producers of medical devices, preventive health products, traditional Chinese medicines, educational institutions, and digital disruptors. China's biopharma sector continues to broaden its bio manufacturing footprint and accelerate its drug development capabilities. However, we could see Western players diversifying their supply chain and moving away from China to reduce their dependency amid rising quality concerns.

[41] Investment opportunities in China's Healthcare Sector after COVID-19, China Briefing, March 25, 2020

Energy

China's energy sector in recovery mode following COVID-19 shock

- The origination of COVID-19 in China, the largest importer of crude oil and LNG, has rattled energy markets globally. While high-impact regions across countries are still under lockdown, China is gradually resuming operations and recovery is likely to be witnessed in the near term across the country's energy sector value chain.
- **Despite COVID-19, China's oil imports are likely to reach record levels by end-2020.** The hefty inventory build-up on declining consumption due to COVID-19 is expected to lower China's oil imports in April to 6.5 mmbpd. However, the availability of cheap crude oil, the recent addition of 2.5 mmbpd of storage, and the expected recovery in consumption from Q2 2020 are likely to boost imports to a record 11 mmbpd by the end of 2020.[42]
  - **China has the second-largest storage capacity after the US**: China accounts for 20% of global strategic reserve capacity and 16% of global commercial storage capacity. Although ~68% of China's storage capacity was utilized by March 9, the available (and anticipated increase) in spare capacity provides a competitive advantage to China, relative to major trading houses and other oil importing countries to store cheap oil and sell it to third parties at a profit when prices recover.[43]
  - **NOCs in production dilemma**: Upstream spending by China's National Oil Companies (NOCs) – China National Petroleum Corp (CNPC), Sinopec, and China National Offshore Oil Corporation (CNOOC) – was at a five-year high in 2019, due to the government's strategy of boosting domestic production. China produces nearly 3.8 mmbpd, with a breakeven cost of ~$41/bbl. If the lower oil prices are sustained, the NOCs will likely reduce output, cut capex, and increase imports. However, a potential agreement between Saudi Arabia and Russia will provide some upside to the oil prices, and may put the NOCs in a dilemma, as to whether they should continue drilling and heed government orders, or protect their bottom-line in the short term.[44, 45]
- **China's refinery runs are accelerating, as opportunities exist for both NOCs and private refiners**. The COVID-19 outbreak significantly lowered domestic consumption of refined products and lowered refiners' average utilization to 63% in January-February, from 79% in 2019.[46] The collapse in oil prices below the $40/bbl bottom reference price used by the Chinese government (to determine the retail prices of gasoline and diesel) along with a gradual rebound in domestic consumption, could prompt refiners to capitalize on the difference between the higher state-set fuel prices and lower oil prices.
  - **Private refiners (known as "teapots"):** The utilization of private refiners, known as teapots, reached a five-year low of 36.9% by the end of February 2020, but rebounded to 65–70% by mid-March.[47] Teapots benefitted significantly from the higher fuel prices set by the state during the 2014 collapse in oil prices, and are likely to adopt a similar strategy of increasing cheap oil imports to generate profits as demand rebounds.
  - **NOCs:** As the COVID-19 outbreak has dented domestic demand for fuels, China's oil products exports are expected to go up to a record high in March, with an overall increase of 58,000 bpd, or 3.9% YoY in Q1 2020.[48] State-owned refiners have been allocated a majority of the refined product export quota, and have the opportunity to increase the export of surplus inventory, primarily to Japan and South Korea (provided margins warrant it). Both the countries have lowered their refinery runs and increased reliance on Chinese exports over the past few months, fostering China's role as a regional refining hub.

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[43] China and the Oil Price War: A Mixed Blessing, Columbia School of International and Public Affairs, March 25, 2020
[44] China and the Oil Price War: A Mixed Blessing, Columbia School of International and Public Affairs, March 25, 2020
[45] Xi Ordered China's Oil Industry to Drill, Then the Crash Came, Bloomberg, March 12, 2020
[46] Oil refiners face reckoning as demand plummets, Reuters, April 2, 2020
[47] China's teapot oil refineries could become 'money-printing machines' amid crude price crash, South China Morning Post, March 12, 2020
[48] China opens fuel export taps as coronavirus slams domestic demand, Economic Times, February 25, 2020

- **China capitalizing on lower LNG prices.** China's LNG imports reached the early-January level of 1.8 million tons in the week of March 23, after hitting a bottom of 0.5 million tons in mid-February. This indicates a significant turnaround in a scenario when buyers were sending *force majeure* notices to sellers due to demand constraints caused by the outbreak. Chinese buyers are likely to continue capitalizing on lower LNG prices as industrial activity rebounds. Further, China may delay its planned gas pipeline projects (e.g., Trans-Asia Natural Gas Pipeline company's expansion of Central Asia – China gas pipeline) as LNG imports are likely to be more favorable than new pipeline development due to expected global LNG oversupply through 2021. This will also provide some relief to US LNG exporters (such as Sempra Energy, Cheniere Energy, and Freeport LNG) that have planned projects targeting China as one of the main markets.[49, 50, 51]

Way Forward

If lower global oil prices are sustained, the Chinese government will likely reconsider its plans of boosting domestic oil production, as the largest producers (CNPC, Sinopec, and CNOOC) may curtail their spending. Lower oil import prices will not only help China to bring down its import bill, but also help increase its energy security by filling strategic reserves. Readers must watch out for the oil imports and domestic production data released by the National Bureau of Statistics (NBS), along with any announcements by the NOCs pertaining to their 2020 spending levels.

Further, lower LNG prices will support the government's polcies of switching from coal to gas for power generation, but may somewhat slow growth in the booming domestic electric vehicle (EV) industry on increased purchase of vehicles running on fossil fuels.

However, if oil product demand and margins in China and other Asian countries do not recover as expected by refiners, their credit risk will likely intensify. This is especially true for the majority of the 44 private refiners in the Shandong province that had already been struggling with increased debt load prior to the COVID-19 crisis. Watch out for the refinery utilization levels in China, Asian oil products margins, along with any change in industrial activity, as a declining correlation between them will likely trigger credit risks for Chinese refiners.

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[50] Gas Could Be In Even Bigger Trouble Than Oil, Oil Price, March 12, 2020
[51] US LNG first wave complete in 2020, Argus, January 2, 2020

Telecom, Hardware, and IT Infrastructure

Telecom Operators, Hardware, and IT Infrastructure have faced setbacks from COVID-19; certain segments may recover, while others may have more uncertainty

Telecom

- The crisis surrounding COVID-19 has impacted telecom operators. Prior to the outbreak, China's mobile market was saturated, with 115% mobile subscription penetration.[52] Subsequently, the market lost 21 million subscribers in Q1 2020 during the initial COVID-19 outbreak. [53] Some telecom equipment suppliers saw a tempory boost in stock performance during the outbreak due to a tempory demand increase as more users worked remotely and consumed more digital content.
- Despite a temporary slowdown in China's 5G network rollouts, many Chinese telecom providers expect to still be on track to meet the 5G launch deadlines set by the government, especially as the virus' spread subsides. Moreover, despite the crisis, China's 5G network buildout is still ahead of that of many other countries. [54, 55, 56]

Hardware and IT Infrastructure

- The crisis has likely impacted hardware and IT infrastructure revenue in China. In early March, IDC predicted PC and smartphone sales would drop 30% in Q1, and server, network, and storage sales would drop 15%, due to both supply and demand challenges (Chinese semiconductors, however, saw some stock boost from the government listing them for domestic substitution). The degree to which the crisis has impacted individual hardware segment supply chains has largely depended on their levels of automation.[57, 58]

Way Forward

In telecom, China's standing relative to other countries in the 5G race will likely remain unchanged, especially since many other countries, particularly the US, China's biggest 5G competitor, will experience similar disruptions to China due to COVID-19. Moreover, the telecom subscriber loss during the outbreak could increase the incentive for 5G post COVID-19, as Chinese telecom companies seek new growth areas to make up for these losses.

In hardware, regional sales of hardware devices may see a steady return, particularly as stores re-open. Even if the COVID-19 recovery is slowed, consumers may begin to adjust to digital shopping and distribution outlets. For IT, as businesses recover from the initial shock of COVID-19, they may once again increase spending on IT systems. Separately, the rapid uptick in digital technology use amid COVID-19 (detailed in the next section) will likely facilitate China's adoption of cloud technologies and 5G.

[52] Telecom sector will shine in post COVID-19 era, says GlobalData, GlobalData, March 27, 2020
[53] COVID-19: Chinese telecoms reportedly lost 21 million users, GizChina, March 31, 2020
[54] China And COVID-19: A Lift For 5-G?, Forbes, February 27, 2020
[55] GSMA: China maintains 5G leadership role in the face of COVID-19, GSMA, March 17, 2020
[56] China Mobile ramps up 5G targets, unaffected by COVID-19, Total Telecom, March 19, 2020
[57] COVID-19: Consequences and opportunities for the ICT sector, Telecom Review, March 05, 2020, IDC* - International Data Corporation
[58] TrendForce presents cccomprehensive aaanalysis of COVID-19 outbreak's impact on global high-tech industry, Trend Force, February 17, 2020

Digital Platforms and Emerging Tech

Digital Platforms and emerging technologies are proving instrumental in battling COVID-19 in China

Digital Platforms

- China's digital penetration has given the country, and by extension its major digital platforms, a strong position to combat the outbreak.
  - China had over 800 million internet users and 56% of global e-commerce market share by the end of 2019.[59]
  - Like other countries, a myriad of digital activities, including remote work, streaming, gaming, and virtual learning, have increased in China during the outbreak as people are being quarantined. China's top digital platforms, Baidu, Alibaba, and Tencent, played a big part in enabling this shift with their various services and platforms, and looked to further facilitate the digital shift by making many of those services free.[60]
  - Alibaba, Tencent, and Baidu have also been partnering with authorities and health officials to offer various platforms and tech solutions, such as AI, to help research, monitor, and contain the outbreak.[61] The wide scale use of these platforms and the large volume of user data has given authorities an unprecedented ability to monitor individuals and the outbreak.

Emerging Tech

- In addition to digital technologies, China has also adopted multiple other emerging technologies, including drones, robots, unmanned retail stores for contactless services and other use cases pertaining to the virus. China has also implemented AI and various data solutions from sources other than Chinese big tech firms to help research, identify, and contain the virus.[62]

Way Forward

Digital platforms in China have only further entrenched themselves into the Chinese economy and citizens' way of life during the COVID-19 outbreak. China will likely be well positioned to adjust to an even more deeply digital economy if recovery from the virus is slow. China's digital platforms have also presented a model for how tech companies in other countries can help combat the virus. Backed by the government, China will also likely continue and expand its adoption of emerging technologies, which could also result in greater privacy and security questions for Chinese citizens. However, other countries can still take note of the other emerging technologies China has adopted to help combat the virus.

[59] What China can teach the world about digital transformation, EY, September 19, 2019
[60] Alibaba, Tencent and Baidu AI make cloud services free during COVID-19 pandemic, TechRepublic, March 18, 2020
[61] Five ways Chinese companies are responding to coronavirus, World Economic Forum, February 20, 2020
[62] The tech on the frontlines of the fight against COVID-19, IT Brief, March 02, 2020

Retail

Improvements in consumer confidence provides opportunities for online retailers and grocers, while others players in restaurants and luxury goods sectors likely to face significant challenges

- Consumer sentiment in China is improving, with 38% of Chinese consumers saying that the worst is over and 43% saying that China is safer from the virus than the rest of the world. Chinese retail businesses are reopening – as of March 19, 100% of malls and 99% of supermarkets were up and running in Shanghai, and almost 73% of restaurants had reopened.[63]
- To avoid any resurgence in COVID-19 cases, the country is taking steps, such as the following:
  - Measuring consumers' body temperature before they enter most supermarkets, restaurants, and other public places
  - Prohibiting central air conditioning in commercial areas
  - Restricting delivery personnel from entering residential areas and assigning pick-up spots
- Despite the increase in consumer sentiment, certain retail sub-sectors, such as restaurants and luxury goods, will continue to struggle this year, as the overall preference turns to essentials. Restaurants are in bad shape as the pandemic has kept consumers at home, and about 60% are unable to cover labor and rental costs.[64] In a recent survey, 86% of the country's surveyed consumers said they would eat at home more often than they did before the outbreak.[65] The trend holds true not only for China, but also for the rest of the world. Starbucks expects the COVID-19 impact to cut its China revenue by $400–430 million in the current fiscal year.[66]
- In the luxury goods sector, 20–30% of sales are dependent on consumers outside their home countries.[67] With travel, an important driver for the sector, coming to a halt around the world, there has been further impact on a sector that was already struggling before COVID-19. Additionally, Chinese consumers account for a third of global luxury goods sales, and brands such as Hermès, Gucci, and Burberry make almost 50% of their annual sales in the Asia-pacific region.[68] We expect the sector to take longer than most others to reach pre-COVID-19 levels of consumption. Chinese consumers still hold the biggest growth opportunity due to their relatively positive consumer sentiment and recovery.

Way Forward

Even though China is ahead of other countries with regard to recovering from the distress caused by COVID-19, it will still take time to tackle the challenges imposed by the pandemic. In the next 3–6 months, the retail industry will have to rebuild its relationships with suppliers, distributors, and customers, and at the same time implement cost reduction and operational efficiency strategies. Additionally, with low-margin consumer staples on the rise and high-margin discretionary items taking a back seat, consumer sentiment will determine the future of the segment.

[63] COVID-19 Consumer Sentiment Snapshot #3: Turning the Tide, BCG, March 30, 2020
[64] Half of Chinese Retailers Risk Collapse Within Six Months, Bloomberg, March 19, 2020
[65] Coronavirus pandemic likely to permanently change dining habits of Asian consumers, South China Morning Post, April 6, 2020
[66] Starbucks says China business is recovering, but second-quarter will take hit to sales from coronavirus closures, CNBC, March 6, 2020
[67] A perspective for the luxury-goods industry during—and after—coronavirus, McKinsey, April 1, 2020
[68] Coronavirus could cause a €40 billion decline in luxury sales in 2020, News Lagoon, April 1, 2020

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